RICS

Draft Treasury Laws Amendment Bill 2017

Summary

Official submission from RICS, Oceania, 16 August 2017

This submission has been prepared by the Royal Institute of Chartered Surveyors (RICS), Oceania. RICS was created by Royal Charter in 1868 and is the leading professional body in the built environment, representing over 118,000 professionals globally. Our Royal Charter obligates RICS to act in the public interest by promoting and enforcing the highest standards in land, property, infrastructure and construction.

The purpose of this submission is to provide an official response to the Draft Treasury Laws Amendment (Housing Tax Integrity) Bill 2017 (the Bill). The Bill clearly seeks to address concerns around the integrity of valuations of second-hand assets in rental properties and the potential for such investor strategies to inflate residential house prices. A key area of the Bill is the amendment of the Income Tax Assessment Act 1997 which seeks to deny income tax deductions for the decline in value of ‘previously used’ depreciating assets (plant and equipment) within residential rental properties.

There are gaps in the current legislation around estimating depreciable values for second hand plant and equipment assets. RICS contends, however, that the Bill goes beyond fixing the integrity issue and, instead of relieving housing affordability stress, may ultimately place upward pressure on housing rents.

RICS posits several options for promoting integrity that retain plant and equipment depreciation as a fundamental element of our tax system.

Key challenges

The Bill targets a single investment class and goes beyond fixing the integrity issue

While there are gaps in current legislation around establishing a depreciable value for second hand plant and equipment, the proposed changes go further than what is necessary to address the integrity issue identified by the Government. Plant and equipment depreciation is a fundamental element of our tax system which should not be removed or altered based on a transaction.

The proposed changes will result in residential property investors (mum and dads, police, nurses and teachers) being treated differently to investors in other asset classes by proposing that the transaction of a property between two parties extinguishes the ability to claim a deduction for depreciation on plant and equipment assets within the property.

The approach proposed in the draft legislation also treats specific plant and equipment assets in residential investment properties differently to other investment classes.

The Tax Commissioner’s published list of plant and equipment assets and effective lives (Tax Ruling 2016/1) identifies 6,507 depreciable assets across all industries, of which 167 relate to residential property investors. These changes are targeting a very small group of assets found in rental properties. Under the proposed changes, a subsequent investor who purchases a business or retail suite such as a café or shop, will have different and sufficiently improved depreciation benefits applicable, compared to a mum and dad investor who purchase a residential property.

At times, these two investors could be within the same building complex with the same assets such as carpets, blinds and hot water systems. They could even share the same lift. However, if these changes were to take effect, one would be able to claim a deduction for depreciation on the lift whereas a subsequent residential owner would not.

It is also important to note that property investors predominantly target and buy second hand properties.

Analysis of data provided by our professionals demonstrates the average depreciation deduction claimed for plant and equipment assets on a typical three-year old residential property, purchased for $600,000, is $21,178 for the first five years. The proposed changes would result in an average loss of $4,236 (deduction) per year in this scenario. Based on a marginal tax rate of 37 percent, an increase of $47 per week in rental income would be required to counter balance this reduction.

These changes will have a major impact on 'mum and dad' investors, reducing the annual deductions claimable and therefore reducing their cash return each year. This could lead to investors being in a tighter financial position, potentially increasing rents and discouraging investors from targeting second hand residential properties, most of which provide affordable housing for renters in lower socio economic areas.

Application of 'previously used' includes assets that were used for non-taxable purposes

From 1 July 2017, the Government intends to limit plant and equipment depreciation deductions to only those outlays (actually) incurred by investors in residential properties. The acquisition of existing plant and equipment assets will be reflected in the cost base for capital gains tax purposes for subsequent investors.

The grandfathering of existing investments is intended. Plant and equipment assets forming part of residential investment properties (including contracts executed up to 7:30pm [AEST] 9 May 2017) will continue to give rise to deductions for depreciation until either the investor no longer owns the asset or the asset reaches the end of its effective life.

Investors who purchase plant and equipment assets for a residential investment property *after* 9 May 2017 will still be able to claim a deduction over the effective life of the asset. However, subsequent owners of a property will be unable to claim deductions for plant and equipment assets *purchased by a previous owner* of that property.

RICS is concerned that assets acquired before 9 May 2017 will still be affected by the proposed changes.

This is not a true grandfathered approach.

Paragraph 2.28 of the Bill outlines the following:

An entity will have 'previously used' an asset if either:

- *the entity is not the first entity that used the asset or installed the asset ready for use (within the meaning of Division 40) other than as trading stock; or*
- *the entity had used the asset wholly for purposes that were not taxable purposes (within the meaning of Division 40) for an income year.*

The second point targets (presumably unintentionally) those who acquired a property for the purpose of living in the property for a period of time and then renting the property out later. This is a popular strategy among property investors who upgrade their primary place of residence and turn their previous residence into a rental property.

Paragraph 2.72 of the Bill mentions that the application of transitional provisions (referring to assets that were previously used prior to the announcement for non-taxable purposes) is to avoid creating unintended incentives for individuals to move personal assets into rental properties.

If assets are moved from a home into an investment property there would be no opportunity to seek any advantage, provided the correct legislation is applied. Assets depreciate from the date of ownership whether they are used for taxable purposes or not. The difference is whether the owner is eligible to claim the decline in value as a deduction. Depreciation starts from the date ownership commences, there is no opportunity for an individual to claim in excess of the value of the asset simply because it was not previously used for taxable purposes.

This section goes beyond addressing the integrity issue identified by the Government. Assets acquired before 9 May 2017 should be allowed to continue to deduct an amount for the decline in value when they are located within an income producing property. The written down value can be easily calculated from when the asset was acquired.

This application will create confusion around when assets within a variety of scenarios qualify for the amendment, considering so many people adopt this strategy in a variety of ways. Some buy new and second hand properties, live in them and then rent the property out. Some move in and out of a rental property over time. Others are first home buyers forced to rent out their property due to changing circumstances often out of their control.

Alternative pathways for promoting integrity

RICS proposes alternative approaches to addressing integrity in the residential property investor class without removing a legitimate deduction available to property investors.

Plant and equipment depreciation is a fundamental element of our tax system which should not be removed from any investment class. Indeed, there are gaps for all industries across the current legislation around estimating depreciable values for second hand plant and equipment assets. A problem is created when an asset is sold. Currently there is no clear costing methodology preventing an updated value being allocated to an asset each time it is purchased which can result in claims being made in excess of the asset's value.

The following options exclude corporate tax entities, large unit trusts or superannuation entities that are not self-managed. They focus on establishing a single historical value for depreciable plant and equipment assets that is carried forward and written down as it is claimed by the first and subsequent owners. When an asset is sold, the written down value will become the opening value and maximum amount claimable by the subsequent owner, until there is no remaining un-deducted value left to claim. This will allocate each plant and equipment asset one value over an effective life regardless of how many owners the asset has had.

Option 1 – 'Adjustments' to general depreciation legislation

RICS suggests the following adjustments to the general depreciation legislation for consideration:

— **Review low value pooling and immediate write-off legislation for residential property investors.**

  For an individual property investor, an asset can be claimed at an accelerated depreciation rate of 18.75% in the year of acquisition and 37.5% each year after for assets that qualify for a low value pool. These assets are qualified for the pool by costing or being valued at less than $1,000. Investors can choose not to use a low value pool. When an asset is allocated to the low value pool its identity is removed and an accelerated rate of depreciation is used. An investor can also utilise immediate write-off legislation, claiming 100% of an assets value in the first year of ownership for assets that are valued at less than $300.

  While there are alternative mechanisms which allow one owner to accelerate the rate of depreciation or completely write-off an asset, it will be difficult to administer a method which ensures the value used is in fact the true un-deducted written down value. This is because the history of claims can be difficult to substantiate on a case by case basis.

— **Allow a prime cost method *only* for establishing a rate of depreciation when determining an asset's un-deducted written down value**.

  This may alleviate confusion for subsequent owners.

  Currently, a property investor can choose either a diminishing value method which accelerates the rate of depreciation and maximises the claim in the first five years or a flat line prime cost method which simply allows for the same yearly claim based upon the rate of depreciation. The prime cost method spreads out the deductions evenly over an assets effective life.

- **Recognise appropriately qualified professionals that meet necessary standards.**

  To ensure estimations of un-deducted value for plant and equipment (if the actual cost is unavailable) meet a consistent standard, and to promote public confidence, RICS suggests a list of qualified professionals be nominated.

  An example of this could be the current scenario as per paragraph 28 of Tax Ruling 97/25 which is used to identify appropriately qualified people who may be able to estimate construction costs (should actual costs be unavailable). RICS also suggests the threshold of the 'appropriately qualified people' list could be elevated by referring expressly to members of organisations that uphold the highest international standards, like RICS.

  http://law.ato.gov.au/atolaw/view.htm?docid=TXR/TR9725/NAT/ATO/00001

Option 2 – Establishing an historical total installed cost

An historical total installed cost may be established; either the actual installed cost or the estimated historical cost of the asset at the time the asset was originally purchased and installed. This value can be easily established and runs in line with current legislated methodology used to establish a value for the structural element of a building when calculating a capital works deduction (division 43).

A rate of depreciation can be calculated using current prime cost methodology, with the annual depreciation amount calculated for the original and subsequent owners. The un-deducted or written down value can then be claimed over the remaining effective life of the asset which is set using effective lives currently outlined by the Commissioner in Tax Ruling 2017/1 (TR 2017/1).

An example of this could be when a property investor purchases a five-year old property with an electric hot water system. Using the make, model and date stamp on the system it was determined that the hot water system was also five years old and installed at the same time the property was built.

In TR 2017/1, the Commissioner determined that an electric hot water system has an effective life of twelve years, resulting in a prime cost depreciation method rate of 8.33%. The historical market value for a five-year old 250 litre hot water system can be determined using product catalogues and asset cost data bases. A typical system would be around $800 when it was purchased five years ago, resulting in a deduction of $66.64 ($800 x 8.33%) per year. Based on the above, the subsequent owner would continue to claim $66.64 per year for the remaining seven years making the total un-deducted value for the subsequent owner $466.48.

Once the total value has been claimed for the hot water system there will be no depreciation deduction available for the current or subsequent owners. If the hot water system is older than twelve years there will be no deduction available. This can be applied to all plant assets in a residential property.

It should be assumed that the assets within a building are the same age as the building itself unless proven otherwise.

The vast majority of plant items have serial numbers, model numbers and some have date stamps. Using this information, the age of assets can be easily determined. An example of this is blinds, they have an order number sticker usually on the top rails so that install date can be determined by manufacturers. Air conditioners, hot water systems, ovens, cooktops, range hoods, garage door motors and many other items have sufficient information including date stamps and serial numbers which enable anyone to accurately determine their age.

In the event an age cannot be proven using serial, make and model numbers then generational features can be matched with product catalogues. These can then be cross referenced with construction of renovation dates identified as per normal practice when determining capital works deductions. It is important that current practices of inspecting a property when needed and obtaining photographic evidence of all plant assets continue.

This information should be stored along with serial, make model numbers so that the age and value of an asset can be substantiated.

Under the current system, when calculating and qualifying capital works deductions (division 43), the age of the building and additional works to the building need to be established. This is achieved in several ways. For example, by reviewing local council records and records of other relevant authorities such as water board connection, construction certification dates and planning registration dates. This information can be substantiated during an onsite inspection. Plant and equipment assets installed at construction will likely be the same age as the building. Adequate proof of age will need to be determined for assets installed during a renovation or replaced after construction by previous owners. This can be achieved using serial, make and model numbers, asset categories, generation differences or receipt of purchase and installation. The vast majority of properties applicable will be less than twelve years old making it easy to determine the building age and assets age.

Assets depreciate regardless of whether they have been used to produce income or used privately. Therefore, assets that have been previously used in a non-tax-deductible capacity will share the same methodology when calculating a written down value.

Option 3 – Total install cost provided with every contract of sale

Legislation could define a method for passing on an un-deducted value to subsequent owners within the contract of sale. A vendor will be required to provide an un-deducted or written down value in every contract of sale regardless of the previous or future use of the building and its assets.

An option could be that in order for a subsequent owner to be eligible to claim depreciation deductions there must be an un-deducted or written down value provided in the contract of sale.

An asset will carry a single value with it from its first use through to the point where the total depreciable value has been claimed. If the asset is older than its effective life it would be allocated a zero value in the contract of sale and there would be no deduction available for subsequent owners.

Consideration will need to be given to this option as it may add a cost to the process of selling a property.

The same depreciation method and asset valuation methodology can be adopted as outlined in Option 2.

Final note

Whilst there are some gaps in the current legislation, the changes proposed in the Bill go well beyond the intent to address an integrity issue. As currently drafted, the changes create a financial disadvantage for residential property investors. By proposing the transaction of a property between two parties extinguishes the ability to claim a deduction for depreciation on plant and equipment assets within the property, residential property investors (mums and dads, police, nurses, and teachers) will be treated differently to investors in other asset classes. Further, absent deductions available under current law, investors may seek to offset losses by increasing rents. The unintended consequence may be a decrease in rental affordability.

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